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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

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In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992:	)	MM Docket No. 93-215
	)	
Rate Regulation; and	)	
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

COMMENTS OF GTE

GTE Service Corporation and its affiliated GTE domestic telephone companies

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July 1, 1994

THEIR ATTORNEY

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SUMMARY

GTE supports a simplified, uniform policy for regulating cable services which provides for symmetrical treatment of the converging video and telecommunications marketplaces. GTE supports the adoption of cost of service rules for cable operators as proposed, conditioned on the premise that the Commission make further refinements to the price cap plan for telephone companies to match the pricing flexibility, and the absence of artificial sharing, depreciation, and productivity measures afforded to cable operators.

The Commission should move to adopt its cost of service rules for cable operators on a permanent basis. The Commission should also affirm its adherence to the price cap/benchmark approach as the primary rate setting tool, with cost of service used only on a "last resort" basis.

The Commission should adopt a rate of return for cable operators electing a cost of service showing that is consistent with the rate of return applied to telephone companies. The Commission should take steps in the LEC price cap review proceeding to ensure that price caps for LECs is on a par with the cable price cap plan, particularly in the areas of earnings sharing and depreciation rates.

USOA guidelines are essential to the achievement of reasonable rates under the cost of service methodology. USOA standards, pattered after the Part 32 Rules for telephone companies, should be adopted for cable cost of service showings.

The benchmark/price cap plan for cable operators must reflect the gains in productivity expected to be achieved by the cable industry in the coming years. The productivity factor adopted for both industries should be based on TFP. The convergence of video and telecommunications technologies dictate the adoption of consistent policies relative to the use of a productivity factor for both cable and telephone industries.

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COMMENTS OF GTE

GTE Service Corporation, on behalf of its affiliated domestic telephone operating companies ("GTE"), submits these Comments in response to the Federal Communications Commission's ("FCC" or "Commission") Report and Order and Further Notice of Proposed Rulemaking.[1]

I. INTRODUCTION.

Pursuant to the directives of the 1992 Cable Act, the Commission adopted a regulatory framework relying on a benchmark rate approach, with cost of service as a safe harbor, as the primary mechanism to set initial rates for regulated cable systems. A "going-forward" mechanism replicating a price cap methodology will be used to

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1 Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation; and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215, CS Docket No. 94-28, FCC 94-39 (released March 30, 1994) ("Cost of Service Order" and "Cost of Service FNPRM").

govern rate adjustments on an ongoing basis.[2] In the Cost of Service Order, the Commission established interim cost of service procedures for setting cost-based rates to accommodate operators with unusually high costs or those that cannot achieve a reasonable rate of return.[3]

Through the policies and rules adopted in the Cost of Service Order, the Commission has properly endeavored to implement the goals of the 1992 Cable Act, including insuring that cable rates charged to consumers reflect only those costs that directly benefit consumers. These cost of service standards were carefully designed to allow regulated cable entities, for whom the benchmark/price cap methodology was unfair, to recover operating expenses and earn a reasonable return on investment while providing some protection to consumers by preventing recovery of unreasonable costs.

In the FNPRM, the Commission tentatively concluded that the cost of service rules should be adopted on a final basis. The Commission requested additional comments on the appropriate rate of return to use in cost of service showings and on whether a Uniform System of Accounts (USOA) should be established for cable operators electing to file cost of service showings. The Notice also sought comment on affiliate transaction requirements, the use of a productivity offset in the cable price cap formula, and whether the Commission should adopt rules for an upgrade incentive plan for cable operators.

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2 In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 94-38, (released March 30, 1994).

3 Cost of Service Order at 8 (¶ 10).

In these Comments, as well as in Comments submitted in the Commission's Docket 92-266 proceeding,[4] GTE supports a simplified, uniform policy for regulating cable services which provides for symmetrical treatment of the converging video and telecommunications marketplaces. Two primary objectives, the efficient allocation of resources and the avoidance of barriers to entry, compel symmetrical regulation and, in particular, refraining from regulating either the voice or video marketplaces in isolation. In instituting price cap regulation for local exchange companies ("LECs") and for cable companies, the Commission sought to provide both LECs and cable companies the incentives to increase efficiency that would apply to a competitive firm -- thereby furnishing an opportunity for an increase in earnings while simultaneously ensuring that rates would fall in real terms. The appropriate measure of success for a price cap plan is the benefit it generates for consumers, not the earnings of the regulated firms. Price cap regulation ensures that earnings are reasonable the same way a competitive market does: by limiting the prices regulated firms can charge.

The price cap rules and regulations that apply to LECs, however, are much more restrictive than those applicable to cable operators. The LEC price cap rules: (1) suppress LEC network efficiencies through the imposition of sharing, (2) constrain LEC innovation through the use of productivity offsets, and (3) encumber LEC investment in the national information infrastructure through the prescription of depreciation rates. In contrast, the price cap plan for the cable industry currently contain none of these restrictions. Cable rates may be adjusted in accordance with changes in inflation, but

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[4] See Comments of GTE, MM Docket 92-266, filed June 29, 1994.

without the exacting of a productivity factor. In addition, cable operators are free to earn any level of profits, and cable operators are free to set depreciation rates in line with the dictates of the marketplace.

With these facts in mind, GTE supports the adoption of cost of service rules for cable operators as proposed, conditioned on the premise that the Commission make further refinements to the price cap plan for telephone companies to match the pricing flexibility, and the absence of artificial sharing, depreciation, and productivity measures afforded to cable operators.

II. THE COST OF SERVICE RULES FOR CABLE OPERATORS SHOULD BE ADOPTED AS PROPOSED IF THE BENEFITS OF THE BENCHMARK/PRICE CAP PLAN ARE TO BE ACHIEVED.

In the Cost of Service Order, the Commission, noting that the cable industry had offered no feasible alternative model, established a format for its cost of service standards consistent with the ratebase/rate of return formula typically used in public utility regulation.[5] GTE supports the adoption of this basic approach because it provides a balanced and reasonable means for cable operators facing extraordinary circumstances or substantial underearnings to establish fair cost-based rates.

In adopting a benchmark/price cap approach to cable regulation, the Commission recognized that a proper price cap regulatory scheme for cable provides important incentives for efficiency and diversity while limiting the monopoly pricing

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[5] Cost of Service Order at 13-14 (¶¶ 24-26).

practices of the past.[6] GTE believes that, in keeping with the policies adopted in the Rate Order, the Commission should refrain from relaxing the cost of service rules. Relaxing the cost of service rules would provide incentives to cable operators to use cost of service rather than the benchmark/price cap methodology as the primary rate justification tool. Such action would destroy the underpinnings of price cap regulation for the cable industry. The Commission's newly-instituted cable cost of service rules provide a more than adequate opportunity for operators to justify the inclusion of any costs in regulated rates. Cable operators are free to rebut presumptively disallowed costs on an individual case basis, or in hardship showings to the extent that such operators establish that their costs ultimately benefit subscribers and resulting rates are not above competitive levels.[7] The cable price cap/benchmark regulatory framework, with cost of service as a backstop, must be allowed to work to achieve the goals of the 1992 Cable Act in order to provide incentives for cable efficiency and diversity while limiting the effect of the cable industry's previous monopoly pricing practices.

In Summary: The Commission should move to adopt its cost of service rules for cable operators on a permanent basis. The Commission should also affirm its adherence to the price cap/benchmark approach as the primary rate setting tool, with cost of service used only on a "last resort" basis.

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[6] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, 8 FCC Rcd 5631, 5777-5778 (1993) ("Rate Order").

[7] Cost of Service Order at 150 (¶ 292).

III. THE COMMISSION SHOULD MAINTAIN REGULATORY PARITY WITHIN THE TELEPHONE INDUSTRY IN DETERMINING RATE OF RETURN AND EARNINGS POLICIES

The principal tool in assuring reasonable regulated cable rates is the price cap mechanism, with the cost of service showing used only as a safeguard. Under the cable price cap plan, cable operators may conceivably earn returns far greater than 11.25% without being required to share a portion of those earnings with ratepayers. The setting of a rate of return component is necessary only to assure that the regulatory scheme meets the constitutional requirements of allowing a reasonable return on investment under cost of service submissions. The Commission carefully weighed the comments and data filed in response to its Notice of Proposed Rulemaking in this proceeding and concluded a rate of return in the range of 10% to 14% would be reasonable for cable operators.[8]

GTE contends that regulatory parity within the telecommunications industry should be a primary Commission objective in selecting a rate of return for cable operators. In previous comments, GTE has advocated the setting of a unified rate of return for cable industry cost of service showings.[9] GTE recommended the use of the Standard & Poors 400 Industrials ("S&P 400") as a surrogate for the risks experienced by investors in regulated cable service. Because the price cap plan was intended to replicate the outcome of a competitive market, it is reasonable to compare cable earnings to those of other firms operating in competitive markets. As GTE has

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[8] Cost of Service Order at ¶ 207.

[9] GTE Comments, MM Docket No. 93-215, filed August 25, 1993, at 27.

demonstrated in its Reply Comments in the LEC Price Cap proceedings,[10] LEC rates of return have been in line with the S&P 400 and are consistent with the current authorized rate of return of 11.25%. Similarly, GTE submits that the Commission should find that the risk faced by regulated cable operators and the LECs are similar and rely on the the S&P 400 in setting a permanent rate of return.

In the current environment, the cable industry faces no greater risks than do the LECs. LECs will begin the construction and implementation of video dialtone services within their local telephone serving areas within the next few years in direct competition with entrenched cable operators. However, meaningful competition to cable systems has only developed in limited areas. It will be several years before video dialtone systems will offer any appreciable competitive threat to existing cable operators. In contrast, competition with LEC exchange access services is significant in several key markets and is expected to intensify rapidly.[11] This competition will include cable operators that plan to enter the local telephone markets, competing directly with LECs for local telephone services.

As stated *supra*, cable operator rates are governed by a price cap plan that is free from restrictions on cable earnings, productivity offsets and depreciation rate prescription. Further, cable operators are completely removed from regulation once effective competition is present, while LECs continue to be constrained by rate

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[10] See GTE Reply Comments, CC Docket 94-1, filed June 29, 1994.

[11] For examples of the type and scope of competition facing GTE in local access markets, see Attachment C, "CAPS Operating in GTE Territory," GTE Comments in CC Docket 94-1, May 9, 1994.

structures that support artificial subsidy flows and pricing restrictions on their most competitive services. In addition, recent remarks made by several Commissioners indicate their willingness to ease some of the cable rate regulation rules.[12] Given these observations, it appears reasonable to expect that the rate of return adopted in this docket for cable cost of service showings be no higher than than of the LECs.

While the determination of an appropriate rate of return for cable is a important step, the Commission must also be cognizant of the disparities in the manner in which earnings and rate of return policies are evolving between price cap plans for the cable industry and the LECs. If maintained, these disparities will have the effect of dampening competition in the converging voice and video markets by creating inefficient allocations of resources and bolstering artificial barriers to entry. The Commission is currently reviewing possible adjustments to LEC price cap indices in the price cap performance review proceeding.[13] The cable industry, in particular, has recommended both a reduction in the LEC authorized rate of return, a corresponding "one time" rate reduction, and the retention of the earnings sharing mechanism.[14] Reductions in LEC returns, according to these parties, should be made due to an observed decline in interest rates and alleged "windfall profits" achieved during the first several years of the LEC price cap plan.

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[12] See remarks of Chairman Hundt, Communications Daily, May 24, 1994, page 2, and remarks of Commissioner Quello, Communications Dail, May 24, 1994, page 4.

[13] See Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 94-10 (released February 16, 1994).

[14] Comments of the California Cable Television Association, CC Docket No. 94-1, filed May 9, 1994, at 5-7.

GTE has demonstrated that an adjustment to the price cap formula for LECs to reflect earnings or interest rates is not warranted. First, the overall weighted average cost of capital for the LECs is in the range of 11.259 percent to 11.714 percent.[15] This range is higher than the 11.25% rate of return the Commission found reasonable in the LEC represcription proceeding on which the current LEC sharing ranges are based.

GTE also maintains that interest expense (as well as other capital costs) is an ordinary cost of doing business, is endogenous, and is accounted for in the price cap formula through the GNP-PI. If the Commission accepts such an imprudent recommendation as that proposed by CCTA, corresponding adjustments to cable operator rates are similarly required to reflect trends in interest rates.

GTE contends that sharing should never have been a part of LEC pricing regulation, just as it has never been part of the cable industry's pricing plans (nor AT&T's). Sharing significantly dilutes efficiency incentives and tilts the balance of risk versus reward at the heart of any incentive regulation plan. Continuing LEC sharing would also be incompatible with any plan to adjust price caps over time to accommodate increasing access competition, such as that planned by cable operators.

Another factor that may significantly impact the level of cable rates as well as cable operator earnings is depreciation expense. In the Cost of Service Order, the Commission concluded that the prescription of depreciation rates for the cable industry was unnecessary and would impose unjustified burdens without providing benefits to

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[15] See GTE Reply Comments, CC Docket 94-1, filed June 29, 1994, at 14.

subscribers.[16] Although the Commission has simplified the depreciation process for LECs, depreciation rates continue to be prescribed by the Commission. By contrast, cable operators may book depreciation expense over the true economic life of their depreciable assets, free from Commission prescribed rates. The regulation of depreciation rates makes no sense under a price cap environment. The Commission has held that cost changes due to changes in depreciation rates are endogenous.[17] Such an approach is reasonable if the regulated entity is free to proceed with implementing investment decisions and appropriate changes without hindrance. The convergence of the telephone and cable industries requires the elimination of the asymmetrical regulation of the cable and LEC depreciation process. While GTE applauds the Commission for taking steps to streamline the LEC depreciation process, it should move further to adopt the "Price Cap Carrier Option" originally proposed in the Depreciation NPRM.

In Summary: The Commission should adopt a rate of return for cable operators electing a cost of service showing that is consistent with the rate of return applied to telephone companies. The Commission should take steps in the LEC price cap review proceeding to ensure that price caps for LECs is on a par with the cable price cap plan, particularly in the areas of earnings sharing and depreciation rates.

IV. A UNIFORM SYSTEM OF ACCOUNTS (USOA) IS ESSENTIAL IN DETERMINING A PROPER COST OF SERVICE SHOWING

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16 Cost of Service Order at 77 (¶ 133).

17 Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6809 ("LEC Price Cap Order").

GTE supports the Commission's establishment of a USOA for cable operators selecting cost of service standards. A determination of whether an operator's cost of service showing is justified cannot be made if every cable operator follows different accounting and allocation rules. USOA guidelines are essential to the achievement of reasonable rates under the cost of service methodology. In Petitions for Reconsideration of the Second Report and Order, certain cable operators have complained that such accounting systems are administratively burdensome to cable operators.[18] Contrary to these complaints, however, uniform accounting methods are an entirely typical and expected component of utility regulation. Moreover, cable operators wishing to avoid USOA guidelines can easily do so by simply setting rates under the price cap/benchmark approach rather than relying on cost of service.

GTE also agrees with the Commission's conclusion that companies with both telephone cable operations should not be burdened by two sets of accounting rules. Companies that are currently subject to Part 32 accounting requirements should be allowed to use those accounting standards for both telephone and cable operations.

In the FNPRM, as part of the proposed USOA rules, the Commission proposed adopting affiliate transaction rules that would apply to cable operators submitting cost of service showings and to cable operators that seek to adjust the benchmark/price cap rates for affiliated programming costs. The Commission tentatively concluded that

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[18] See Petition for Reconsideration of Comcast Cable Communications, Inc., MM Docket No. 92-266, filed May 16, 1994, at page 22.

proposed changes to affiliate transaction rules for telephone companies should apply to cable operators.[19]

GTE supports application of the Commission's affiliate transactions rules to cable operators. The proposed rules are necessary to prevent cable operators from manipulating transactions with nonregulated affiliates in order to justify higher rates. Moreover, the affiliate transactions rules proposed by the Commission are consistent with section 616 of the Communications Act.[20] Congress enacted that section in order to protect video programming vendors from the anti-competitive actions of multichannel video programming distributors (MVPDs). Congress specifically found that cable operators frequently act in ways that favor affiliated program distributors and stifle programming distribution. GTE believes that Cable operators' long history of anti-competitive conduct necessitates careful Commission oversight of affiliate transactions.

In Summary: USOA guidelines are essential to the achievement of reasonable rates under the cost of service methodology. USOA standards, pattered after the Part 32 Rules for telephone companies, should be adopted for cable cost of service showings.

V. A PRODUCTIVITY OFFSET BASED ON TOTAL FACTOR PRODUCTIVITY SHOULD BE INCORPORATED IN THE BENCHMARK/PRICE CAP FORMULA

In the Notice, the Commission observed that future cable industry productivity gains are expected to be analogous to those realized by other telecommunications

19 Cost of Service FNPRM at 157-160 (¶¶ 309-313).

20 47 U.S.C. § 536.

companies.[21] Increasingly efficient capital inputs in the form of advanced communications equipment such as compression technology, digital switches, and fiber optic technology provide opportunities for cable firms to realize substantial productivity gains over the next few years. Based primarily on a study submitted by the New Jersey Board of Regulatory Commissioners, the Commission proposed adopting a 2 percent productivity offset as part of the benchmark for regulated cable rates. The Notice seeks comment and additional data supporting other measures of productivity for cable systems.[22]

The GNP-PI factor used to make ongoing adjustments to regulated rates is an inflation measure that embodies economy-wide productivity gains and price changes. The productivity offset to the GNP-PI is a measure of how firms regulated under price caps are expected to outperform economy-wide productivity gains. The relevant measure on which to base the productivity factor is total factor productivity (TFP). This measure includes all inputs and outputs to the production process, capturing all changes in productivity over time. In both the AT&T and LEC price cap proceedings, the Commission incorporated a productivity offset recognizing the productivity gains these carriers were expected to achieve under price cap regulation. Clearly, given the rapid advances in video and telecommunications technology, cable operators will achieve productivity levels that exceed those of the economy as a whole indicating the need for a productivity offset in the cable price cap formula.

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[21] Cost of Service FNPRM at 162 (¶ 319).

[22] Id. at 160-163 (¶¶ 314-323).

Recent studies of total factor productivity of the LECs revealed economy-wide TFP growth of approximately 0.9 percent annually since 1984 with TFP growth of the LECs exceeding that of the general economy by 1.7 percent.[23] The 1.7 percent productivity factor advocated by GTE for the LEC price cap formula is similar to that endorsed by the New Jersey Commission -- the only cable specific value submitted to the Commission. Regulatory symmetry dictates that the cable and telephone industries should have similar productivity offsets incorporated into their price cap formulas. GTE believes that the productivity factor for cable should be based on TFP and should be similar to that of the telephone industry.

In the Rate Order, the Commission adopted a productivity factor of zero partially based on the claim that productivity gains were reflected in the benchmark procedure in which reductions are realized in per channel rates as channel capacity expands.[24] GTE disagrees with that reasoning. The productivity offset must include not only movements along the unit cost curve (scale economies), but also downward shifts of the curve itself (technological gains). The benchmark relates only to the initial level of TFP (unit cost), whereas the productivity offset properly relates to the growth in

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[23] See Comments of USTA, Docket 94-1, May 9, 1994, Attachment 6, "Productivity of the Local Telephone Operating Companies," Lauritis R.Christensen, Phillip E. Schoech and Mark E. Meitzen.

[24] Rate Order, 8 FCC Rcd at 5781-5782 (at ¶ 238).

TFP.[25] Thus, the benchmark procedure provides no support for setting a zero productivity offset.

In recent months, Chairman Hundt has expressed his personal view that there may be no need for a productivity offset for cable operators.[26] In contrast, the Commission's LEC Price Cap Review notice asks for comments on the need to potentially increase the productivity factor of LECs to reflect higher average earnings achieved under price caps and declining interest rates. Totally abandoning one of the most fundamental aspects of price caps for cable operators while adhering to such a policy in the LEC price cap plan makes no sense. GTE maintains that if the Commission retains a zero productivity factor for cable, it should eliminate or substantially reduce the productivity factor for the LECs.

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[25] For a discussion and analysis of TFP and the proposed productivity offset for the cable industry see Statement of Dr. Mark Schankerman, London School of Economics, Attachment to GTE Comments, Docket 92-266, August 25, 1993.

[26] Remarks of Chairman Reed E. Hundt at the National Cable Television Association Convention, New Orleans, LA, May 24, 1994.

In Summary: The benchmark/price cap plan for cable operators must reflect the gains in productivity expected to be achieved by the cable industry in the coming years. The productivity factor adopted for both industries should be based on TFP. The convergence of video and telecommunications technologies dictate the adoption of consistent policies relative to the use of a productivity factor for both cable and telephone industries.

Respectfully submitted,

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Certificate of Service

I, Judy R. Quinlan, hereby certify that copies of the foregoing "Comments of GTE" have been mailed by first class United States mail, postage prepaid, on the 1st day of July to all parties of record.

Judy R. Quinlan

Judy R. Quinlan